CHAPTER 2

The double life of Daniel Defoe
How did the rich countries become rich?

Daniel Defoe, the author of *Robinson Crusoe*, had a colourful life. Before writing novels, he was a businessman, importing woollen goods, hosiery, wine and tobacco. He also worked in the government in the royal lotteries and in the Glass Duty Office that collected the notorious 'window tax', a property tax levied according to the number of a house's windows. He was also an influential author of political pamphlets and led a double life as a government spy. First he spied for Robert Harley, the Tory speaker of the House of Commons. Later, he complicated his life even further by spying for the Whig government of Robert Walpole, Harley's political arch-enemy.

As if being a businessman, novelist, tax collector, political commentator and spy wasn't providing sufficient stimulus, Defoe was also an economist. This aspect of his life is even less well known than his spying. Unlike his novels, which include *Robinson Crusoe* and *Moll Flanders*, Defoe's main economic work, *A Plan of the English Commerce* (1728), is almost forgotten now. The popular biography of Defoe by Richard West does not mention the book at all, while the award-winning biography by Paula Backscheider mentions it largely in relation to marginal subjects, such as Defoe's view on native Americans.[1] However, the book was a thorough and insightful account of Tudor industrial policy (under

England's Tudor monarchs) that has much to teach us today.

In the book (henceforth *A Plan)*, Defoe describes how the Tudor monarchs, especially Henry VII and Elizabeth I, used protectionism, subsidies, distribution of monopoly rights, government-sponsored industrial espionage and other means of government intervention to develop England's woollen manufacturing industry—Europe's high-tech industry at the time. Until Tudor times, Britain had been a relatively backward economy, relying on exports of raw wool to finance imports. The woollen manufacturing industry was centred in the Low Countries (today Belgium and the Netherlands), especially the cities of Bruges, Ghent and Ypres in Flanders. Britain exported its raw wool and made a reasonable profit. But those foreigners who knew how to convert the wool into clothes were generating much greater profits. It is a law of competition that people who can do difficult things which others cannot will earn more profit. This is the situation that Henry VII wanted to change in the late 15$^{\text{th}}$ century.[2] According to Defoe, Henry VII sent royal missions to identify locations suited to woollen manufacturing.[3] Like Edward III before him, he poached skilled workers from the Low Countries.[4] He also increased the tax on the export of raw wool, and even temporarily banned its export, in order to encourage further processing of the raw material at home. In 1489, he also banned the export of unfinished cloth, save for coarse pieces below a certain market value, in order to promote further processing at home.[5] His son, Henry VIII, continued the policy and banned the export of unfinished cloth in 1512, 1513 and 1536.

As Defoe emphasizes, Henry VII did not have any illusions as to how quickly the English producers could catch up with their sophisticated competitors in the Low Countries.[6] The King raised export duties on raw wool only when the English industry was established enough to handle the volume of wool to be processed. Henry then quickly withdrew his ban on raw wool exports when it became clear that Britain simply did not have the capacity to process all the raw wool it produced.[7] Indeed, according to *A Plan*, it was not until 1578, in the middle of Elizabeth I's reign (1558–1603)—nearly 100 years after Henry VII had started his 'import substitution industrialization' policy in 1489—that Britain had sufficient processing capacity to ban raw wool exports totally.[8] Once in place, however, the export ban drove the competing manufacturers in the Low Countries, who were now deprived of their raw materials, to ruin.

Without the policies put in place by Henry VII and further pursued by his successors, it would have been very difficult, if not impossible, for Britain to have transformed itself from a raw-material exporter into the European centre of the then high-tech industry. Wool manufacture became Britain's most important export industry. It provided most of the export earnings to finance the massive import of raw materials and food that fed the Industrial Revolution.[9] *A Plan* shatters the foundation myth of capitalism that Britain succeeded because it figured out the true path to prosperity before other countries—free market and free trade.

Daniel Defoe's fictional hero, Robinson Crusoe, is often used by economics teachers as the pure example of 'rational economic man', the hero of neo-liberal free-market economics. They claim that, even though he lives alone, Crusoe has to make 'economic' decisions all the time. He has to decide how much to work in order to satisfy his desire for material consumption and leisure. Being a rational man, he puts in precisely the minimum amount of work to achieve the goal. Suppose Crusoe then discovers another man living alone on a nearby island. How should they trade with each other? The free-market theory says that introducing a market (exchange) does not fundamentally alter the nature of Crusoe's situation. Life goes on much as before, with the additional consideration that he now needs to establish the rate of exchange between his product and his neighbour's. Being a rational man, he will continue to make the right decisions. According to free-market economics, it is precisely because we are like Crusoe that free markets work. We know exactly what we want and how best to achieve it. Consequently, leaving people to do what they desire and know to be good for themselves is the best way to run the economy. Government just gets in the way.

The kind of economics that underpins Defoe's *Plan* is exactly the opposite of Robinson Crusoe economics. In *A Plan*, Defoe clearly shows that it was not the free market but government protection and subsidies that developed British woollen manufacturing. Defying signals from the market that his country was an efficient raw wool producer and should remain so, Henry VII introduced policies that deliberately distorted such unwelcome notions. By doing so, he started the process that eventually transformed Britain into a leading manufacturing nation. Economic development requires people like Henry VII, who build a new future, rather than people like Robinson Crusoe, who live for today. Thus, in addition to his double life as a spy, Defoe also led a double life as an economist—without realizing it, he created the central character in free market economics in his fictional work, yet his own economic analysis clearly illustrated the limits of free market and free trade.

2.1. *Britain takes on the world*

Defoe started his double life as a spy for the Tory government, but later, as I mentioned, he spied for the Whig government of Robert Walpole. Walpole is commonly known as the first British prime minister, although he was never called that by his contemporaries.[10] Walpole was notorious for his venality—he is said to have 'reduced corruption to a regular system'. He deftly juggled the disbursement of aristocratic titles, government offices and perks in order to maintain his power base, which enabled him to remain the prime minister for a staggering 21 years (1721–42). His political skills were immortalized by Jonathan Swift in his novel, *Gulliver's Travels*, in the character of Flimnap. Flimnap is the prime minister of the empire of Lilliput and champion of Dance of the Rope, the frivolous method by which the holders of high offices in Lilliput are selected.[11] Yet Walpole was a highly competent economic manager. During his time as chancellor of the exchequer, he enhanced the creditworthiness of his government by creating a 'sinking fund' dedicated to repaying the debts. He became prime minister in 1721 because he was considered the only person who had the ability to manage the financial mess left behind by the infamous South Sea Bubble.*

Upon becoming prime minister, Walpole launched a policy reform that dramatically shifted the focus of British industrial and trade policies. Prior to Walpole, the British government's policies were, in general, aimed at capturing trade through colonization and the Navigation Act (which required that all trade with Britain should be conducted in British ships) and at generating government revenue. The promotion of woollen manufacturing was the most important exception, but even that was partly motivated by the desire to generate more government revenue. In contrast, the policies introduced by Walpole after 1721 were deliberately aimed at promoting manufacturing industries. Introducing the new law, Walpole stated, through the King's address to Parliament: 'it is evident that nothing so much contributes to promote the public well-being as the exportation of manufactured goods and the importation of foreign raw matrial'.[12] Walpole's 1721 legislation essentially aimed to protect British manufacturing industries from foreign competition, subsidize them and encourage them to export.[13] Tariffs on imported foreign manufactured goods were significantly raised, while tariffs on raw materials used for manufacture were lowered, or even dropped altogether. Manufacturing exports were encouraged by a series of measures, including export subsidies.[14] Finally, regulation was introduced to control the quality of manufactured products, especially textile products, so that unscrupulous manufacturers could not damage the reputation of British products in foreign markets.[15] These policies are strikingly similar to those used with such success by the 'miracle' economies of East Asia, such as Japan, Korea and Taiwan, after the Second World War. Policies that many believe, as I

*The South Sea Company was set up in 1711 by Robert Harley, Defoe's first spymaster, and was granted exclusive trading rights in Spanish South America. It made little actual profit, but talked up its stock with the most extravagant rumours of the value of its potential trade. A speculative frenzy developed around its shares in 1720, with its stock price rising by ten times in seven months between January and August 1720. The stock price then started tailing and, by early 1721, was back where it had been in January 1720.

myself used to, to have been invented by Japanese policy-makers in the 1950s - such as 'duty drawbacks on inputs for exported manufactured *products** and the imposition of export product quality standards by the *government*—were actually early British inventions.[16]

This is a practice where the government sets the minimum quality standards for export products and punishes those exporters who do not meet them. This is intended to prevent substandard export products tarnishing the image of the exporting country. It is particularly useful when products do not have well-recognized brand names and, therefore, are identified by their national origin.

Walpole's protectionist policies remained in place for the next century, helping British manufacturing industries catch up with and then finally forge ahead of their counterparts on the Continent. Britain remained a highly protectionist country until the mid-i9th century. In 1820, Britain's average tariff rate on manufacturing imports was 45–55%, compared to 6–8% in the Low Countries, 8–12% in Germany and Switzerland and around 20% in France.[17] Tariffs were, however, not the only weapon in the arsenal of British trade policy. When it came to its colonies, Britain was quite happy to impose an outright ban on advanced manufacturing activities that it did not want developed. Walpole banned the construction of new rolling and slitting steel mills in America, forcing the Americans to specialize in low value-added pig and bar iron, rather than high value-added steel products.

Britain also banned exports from its colonies that competed with its own products, home and abroad. It banned cotton textile imports from India ('calicoes'), which were then superior to the British ones. In 1699 it banned the export of woollen cloth from its colonies to other countries (the Wool Act), destroying the Irish woollen industry and stifling the emergence of woollen manufacture in America.

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*This is a practice where a manufacturer exporting a product is paid back the tariff that it has paid for the imported inputs used in producing the product. This is a way of encouraging exports.

Finally, policies were deployed to encourage primary commodity production in the colonies. Walpole provided export subsidies to (on the American side) and abolished import taxes on (on the British side) raw materials produced in the American colonies such as hemp, wood and timber. He wanted to make absolutely sure that the colonist stuck to producing primary commodities and never emerged as competitors to British manufacturers. Thus they were compelled to leave the most profitable 'high-tech' industries in the hands of Britain which ensured that Britain would enjoy the benefits of being on the cutting edge of world development.[18]

2.2. *The double life of the British economy*

The world's first famous free-market economist, Adam Smith, vehemently attacked what he called the 'mercantile system' whose chief architect was Walpole. Adam Smith's masterpiece, *The Wealth of Nations,* was published in 1776, at the height of the British mercantile system. He argued that the restrictions on competition that the system was producing through protection, subsidies and granting of monopoly rights were bad for the British *economy.*[*]

Adam Smith understood that Walpole's policies were becoming obsolete. Without them, many British industries would have been wiped out before they had had the chance to catch up with their superior rivals abroad. But once British industries had become internationally competitive, protection became less necessary and even counter-productive. Protecting industries that do not need protection any more is likely to make them complacent and inefficient, as Smith observed. Therefore, adopting free trade was now increasingly in Britain's interest. However, Smith was somewhat ahead of his time. Another generation would pass before his views became truly influential, and it was not until 84

[*] However, Smith was a patriot even more than he was a free market economist. He supported free market and free trade only because he thought they were good for Britain, as we can see from his praise of the Navigation Acts—the most blatant kind of 'market-distorting' regulation—as 'the wisest of all the commercial regulations of England'.

years after *The Wealth of Nations* was published that Britain became a genuine free trading nation.

By the end of the Napeolenic Wars in 1815, four decades after the publication of *The Wealth of Nations*, British manufacturers were firmly established as the most efficient in the world, except in a few limited areas where countries like Belgium and Switzerland possessed technological leads. British manufacturers correctly perceived that free trade was now in their interest and started campaigning for it (having said that, they naturally remained quite happy to restrict trade when it suited them, as the cotton manufacturers did when it came to the export of textile machinery that might help foreign competitors). In particular, the manufacturers agitated for the abolition of the Corn Laws that limited the country's ability to import cheap grains. Cheaper food was important to them because it could lower wages and raise profits.

The anti-Corn Law campaign was crucially helped by the economist, politician and stockmarket player, David Ricardo. Ricardo came up with the theory of comparative advantage that still forms the core of free trade theory. Before Ricardo, people thought foreign trade makes sense only when a country can make something more cheaply than its trading partner. Ricardo, in a brilliant inversion of this commonsensical observation, argued that trade between two countries makes sense even when one country can produce everything more cheaply than another. Although this country is more efficient in producing everything than the other, it can still gain by specializing in things in which it has the greatest cost advantage over its trading partner. Conversely, even a country that has no cost advantage over its trading partner in producing any product can gain from trade if it specializes in products in which it has the least cost disadvantage. With this theory, Ricardo provided the 19 th-century free traders with a simple but powerful tool to argue that free trade benefits every country.

Ricardo's theory is absolutely right—within its narrow confines. His theory correctly says that, *accepting their current levels of technology as given,* it is better for countries to specialize in things that they are relatively better at. One cannot argue with that.

His theory fails when a country wants to acquire more advanced technologies so that it can do more difficult things that few others can do—that is, when it wants to develop its economy. It takes time and experience to absorb new technologies, so technologically backward producers need a period of protection from international competition during this period of learning. Such protection is costly, because the country is giving up the chance to import better and cheaper products. However, it is a price that has to be paid if it wants to develop advanced industries. Ricardo's theory is, thus seen, for those who accept the *status quo* but not for those who want to change it.

The big change in British trade policy came in 1846, when the Corn Laws were repealed and tariffs on many manufacturing goods were abolished. Free trade economists today like to portray the repeal of the Corn Laws as the ultimate victory of Adam Smith's and David Ricardo's wisdom over wrong-headed mercantilism.[19] The leading free trade economist of our time, Jagdish Bhagwati of Columbia University, calls this a 'historic transition'.[20] However, many historians familiar with the period point out that making food cheaper was only one aim of the anti-Corn Law campaigners. It was also an act of 'free trade imperialism' intended to 'halt the move to industrialisation on the Continent by enlarging the market for agricultural produce and primary materials'.[21] By opening its domestic agricultural market wider, Britain wanted to lure its competitors back into agriculture. Indeed, the leader of the anti-Corn Law movement, Richard Cobden, argued that, without the Corn Laws: 'The factory system would, in all probability, not have taken place in America and Germany. It most certainly could not have flourished, as it has done, both in these states, and in France, Belgium and Switzerland, through the fostering bounties which the high-priced food of the British artisan has offered to the cheaper fed manufacturer of those countries'.[22] In the same spirit, in 1840, John Bowring of the Board of Trade, a key member of the anti-Corn Law League, explicitly advised the member states of the German *Zollverein* (Custom Union) to specialize in growing wheat and sell the wheat to buy British manufactures.[23] Moreover, it was not until 1860 that tariffs were completely abolished. In other words, Britain adopted free trade only when it had acquired a technological lead over its competitors 'behind high and long-lasting tariff barriers', as the eminent economic historian Paul Bairoch once put it.[24] No wonder Friedrich List talked about 'kicking away the ladder'.

2.3. *America enters the fray*

The best critique of Britain's hypocrisy may have been written by a German, but the country that best resisted Britain's ladder-kicking in terms of policy was not Germany. Nor was it France, commonly known as the protectionist counterpoint to free-trading Britain. In fact, the counterbalance was provided by the US, Britain's former colony and today's champion of free trade.

Under British rule, America was given the full British colonial treatment. It was naturally denied the use of tariffs to protect its new industries. It was prohibited from exporting products that competed with British products. It was given subsidies to produce raw materials. Moreover, outright restrictions were imposed on what Americans could manufacture. The spirit behind this policy is best summed up by a remark William Pitt the Elder made in 1770. Hearing that new industries were emerging in the American colonies, he famously said: '[The New England] colonies should not be permitted to manufacture so much as a horseshoe nail'.[25] In reality, British policies were a little more lenient than this may imply: some industrial activities were permitted. But the manufacture of high-technology products was banned.

Not all Britons were as hard-hearted as Pitt. In recommending free trade to the Americans, some were convinced that they were helping them. In his *Wealth of Nations*, Adam Smith, the Scottish father of free market economics, solemnly advised the Americans not to develop manufacturing. He argued that any attempt to 'stop the importation of European manufactures' would 'obstruct instead of promoting the progress of their country towards real wealth